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Supreme Court, U.S.
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No. 03-171

In The

Supreme Court of the United States

STERLING HOLDING COMPANY, LLC, and
NATIONAL SEMICONDUCTOR CORPORATION,

Petitioners,

v.

MARK LEVY,

Respondent.

**On Petition For A Writ Of Certiorari
To The United States Court Of Appeals
For The Third Circuit**

BRIEF IN OPPOSITION

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I.

STATEMENT OF THE CASE

A. The Nature of the Case

This is an action arising under Section 16(b) of the Securities Exchange Act of 1934, 15 U.S.C. §78p(b), brought for the benefit of Fairchild Semiconductor International, Inc. ("Fairchild" or the "Company") by Mark Levy, a Fairchild shareholder. A-19. Plaintiff-respondent alleges that defendants Sterling Holding Company, LLC ("Sterling") and National Semiconductor Corporation ("National"), collectively referred to as "petitioners", realized substantial profits through short-swing purchases and sales of Fairchild common stock ("Common Stock"), at times when petitioners were statutory insiders for purposes of Section 16(b). A-21-25. Section 16(b) requires disgorgement of such profits to the Company. A-19.

B. Section 16(b) is an Important Remedial Statute Representing a Legislative Judgment That Certain Forms of Insider Trading Should be Prohibited Because of Their Potential for Speculative Abuse

The Securities Exchange Act of 1934 ("Exchange Act" or the "1934 Act") was intended principally to protect investors against the manipulation of stock prices. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 195 (1976) (citing S. Rep. No. 792, 73d Cong., 2d Sess., 1-5 (1934)). This policy is set forth in Section 2(4) of the Exchange Act, 15 U.S.C. §78b(4), titled "Necessity for Regulation," which states:

> National emergencies, which produce widespread unemployment and the dislocation of trade . . . and industry . . . are precipitated, intensified and

> prolonged by manipulation and sudden fluctuations of security prices and by excessive speculation on such exchanges and markets. . . .

"Prohibiting short-swing trading by insiders with nonpublic information was an important part of Congress' plan in the 1934 Act to 'insure the maintenance of fair and honest markets' and to eliminate such trading." *Gollust v. Mendell*, 501 U.S. 115, 121 (1991) (quoting 15 U.S.C. §78b). "Congress thought that ***all*** short-swing trading by directors and officers was vulnerable to abuse because of their intimate involvement in corporate affairs." *Foremost-McKesson, Inc. v. Provident Secs. Co.*, 423 U.S. 232, 253 (1976) (emphasis added). "[T]he only method Congress deemed effective to curb the evils of insider trading was a flat rule taking the profits out of a class of transactions in which the possibility of abuse was believed to be intolerably great." *Reliance Electric Co. v. Emerson Electric Co.*, 404 U.S. 418, 422 (1972).

Section 16(b) was enacted based on evidence that "insiders actually manipulated the market price of their stock by causing a corporation to follow financial policies calculated to produce sudden changes in market prices in order to obtain short swing profits." *Interpretative Release on Rules Applicable to Insider Reporting and Trading*, Exchange Act Release No. 18114, 46 FR 48147 (Sept. 24, 1981) ("Release No. 18114"). Section 16(b) destroys this incentive by depriving insiders of the ability to profit from short-term price fluctuations. *See Kern County Land Co. v. Occidental Petroleum Corp.*, 411 U.S. 582, 591 (1973). *See also* S. Thel, *The Genius of Section 16: Regulating the Management of Publicly Held Companies*, 42 Hastings L. J. 391, 433 & n.141 (1991).

Any suggestion that initial public offerings of stock ("IPOs") are not subject to speculative abuse would be remarkable in light of the many recent revelations of wrongdoings relating thereto. *See generally In re Initial Public Offering Sec. Litig.*, 241 F. Supp. 2d 281 (S.D.N.Y. 2003). Petitioners have acknowledged that Fairchild's IPO was a "hot" offering (A-48) – one which is severely underpriced compared to its true value. *See IPO Sec. Litig.*, 241 F. Supp. 2d at 300.

The Securities and Exchange Commission ("SEC" or the "Commission") and other regulators have documented the multitude of potential abuses that arise from such conduct. These abuses reached a fever pitch in the hot IPO market of 1998-2000, when Fairchild's IPO took place. *See IPO Sec. Litig.*, 241 F. Supp. 2d at 300-308. Insiders, buying at the severely discounted price necessary to make an offering "hot" with the goal of turning a quick profit by selling in the after-market – *i.e.*, what petitioners did here – comprises precisely the sort of speculative abuse which the Exchange Act, including Section 16(b), seeks to prevent. Indeed, CFSB First Boston, a co-lead underwriter for Fairchild's IPO, has entered into a consent decree with the SEC with respect to exactly such conduct. *See* http://www.sec.gov/litigation/complaints/judglr17327.htm.[1]

[1] Rule 201 of the Federal Rules of Evidence allows a court to take judicial notice of facts contained in SEC filings. *See, e.g., Bryant v. Avado Brands, Inc.*, 187 F.3d 1271, 1275-81 (11th Cir. 1999); *accord Massachusetts v. Nescott*, 431 U.S. 322, 323 n.2 (1977).

C. Statement of Facts

Fairchild's capital structure consisted of: (i) Class A common stock (the "Common Stock"); (ii), Class B common stock; and (iii) 12% Series A Cumulative Compounding Preferred Stock (the "Preferred Stock"). A-22 and A-24. At the time it was issued, the Preferred Stock was *not* convertible into Common Stock. There were approximately 60 shareholders of Fairchild, with Sterling and National being the two most dominant shareholders. A-24 and A-54.

On July 26, 1999, a majority of the shareholders of all three classes of Fairchild stock approved by written consent a restatement of Fairchild's Certificate of Incorporation that contained an amendment authorizing the conversion of the Preferred Stock into Common Stock. A-25 and A-228. On August 3, 1999, Fairchild's IPO registration statement for the Common Stock under Section 12 of the Exchange Act became effective. A-23. On August 9, 1999, Fairchild filed its Restated Certificate of Incorporation, and the Preferred Stock was used as currency to purchase Common Stock at the price at which the Common Stock was sold to the underwriters in the IPO ($17.39 per share). A-25. As a result, both Sterling and National acquired substantial additional shares of Common Stock. A-25 and A-180-A-181. Within six months thereafter, on or about January 19, 2000, both Sterling and National sold millions of shares of Common Stock, realizing substantial short-swing insider profits. A-24-25.[2] All of the transactions were voluntary.

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[2] Petitioners claim that their transactions were merely routine. That is not the case. The custom in the securities industry is to prohibit

(Continued on following page)

D. Proceedings in the District Court

Petitioners moved to dismiss the Complaint pursuant to Rule 12(b)(6) of the Federal Rules of Civil Procedure (A-14), and oral argument on the motion was held before Judge McKelvie on July 27, 2001. A-30. On September 12, 2001, Judge McKelvie recused himself, whereupon the case was transferred to District Judge Gregory M. Sleet. A-17. On February 5, 2002, the district court issued a Memorandum and Order dismissing the Complaint.

E. Proceedings in Another District Court Action

After Judge Sleet's decision dismissing the action based on Rule 16b-7, 17 C.F.R. §240.16b-7, Chief Judge Robinson of the District of Delaware was presented with a similar motion to dismiss made in an unrelated Section 16(b) action. In ruling on the motion to dismiss, Judge Robinson rejected Judge Sleet's analysis, stating:

> Nevertheless, with the exception of *Levy*, no court has exempted a reclassification, under the ambit of Rule 16b-7 or otherwise, as a matter of law. Rather, courts have considered the facts and circumstances surrounding each transaction before concluding that a particular transaction did not pose the risk of speculative, insider "short-swing" trading profits that Section 16(b) sought to prevent.

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sales of an issuer's stock by insiders for six months following the completion of an IPO, as was originally done here. *E.g.*, A-84. Yet, exercising their corporate influence, petitioners arranged to sell millions of shares less than six months after the IPO. *See* A-26.

Rosenberg v. Harris Corp., 2002 U.S. Dist. LEXIS 16200 at *6 (D. Del. Aug. 1, 2002).

F. Proceedings in the Court of Appeals

Oral argument before the court of appeals was held on October 29, 2002. There was no *amicus* participation. On December 19, 2002, the court of appeals reversed. *Levy v. Sterling Holding Co., LLC,* 314 F.3d 106. The Clerk subsequently granted petitioners' motion to enlarge from 15 to 60 days the time within which to file a petition for rehearing. That petition was timely filed.

The court of appeals denied a motion by the Securities Industries Association to file an *amicus* brief in support of the petition for rehearing. Appearing for the first time in the lawsuit, the Commission filed a motion for leave to file an *amicus* brief in support of the petition for rehearing. Respondent opposed the motion on the grounds that the Commission lacked enforcement or adjudicative authority with respect to the rules it promulgates for exemptions from Section 16(b) liability, and that it had been dilatory, having evinced no interest in this case either at trial or appellate levels.

In response to the Commission's motion, the court of appeals directed it to state when it first learned of the underlying litigation. The Commission responded by providing information as to when the staff of its General Counsel initially became aware of the action, acknowledging that its attention was invited to the lawsuit in a letter the Commission's Division of Corporate Finance received in March 2001.

In that supplemental submission, the SEC stated that it had not appeared earlier because the district court decision was correct and it had no reason to suspect that it would be reversed. Yet, in reality, when the case reached the court of appeals for oral argument, there was a split on the district courts between Judge Sleet and Chief Judge Robinson as to the correct interpretation of Rule 16b-7 and there had been no ruling on Rule 16b-3(d) though, during oral argument, Judge McKelvie had indicated that he did not seriously credit that argument. *See* A-37.

After receiving the SEC's supplemental submission, the court of appeals accepted the Commission's *amicus* brief for filing "as such." The court of appeals then denied the petition for rehearing by a vote of 7-3. A panel of the court of appeals subsequently unanimously denied petitioners' motion to stay entry of its mandate pending the filing of a petition for a writ of certiorari.

II.

NEITHER THE RECORD NOR THE DECISION BELOW RAISE THE QUESTION PRESENTED BY THE PETITION

Petitioners artfully frame the question presented in their writ as being whether the court of appeals was free to disregard the plain language of Rules 16b-3 and 16b-7. However, in reality, the court of appeals has faithfully adhered to the plain language as well as the regulatory history of those rules and statutory purpose of Section 16(b) to which they relate. Also, Petitioners neglect to mention that the SEC has no enforcement or adjudicative authority with respect to those rules. Therefore, the question presented should more appropriately be framed as whether a

court must disregard the plain language of rules combined with their regulatory history and underlying statutory purpose based upon an opinion of a regulatory agency, which has no administrative or enforcement authority over the rules at issue, set forth in the first time in an *amicus* submission.

III.

THE PETITION FOR A WRIT OF CERTIORARI SHOULD BE DENIED

Nothing in this case should command the attention of the Court. Contrary to petitioners' assertions, in the eight months since the court of appeals ruled, there has been no evidence of any disruption in the routine functioning of the securities markets attributable to the decision.

The court of appeals has done what courts around the country do every day – interpret statutory language.[3] The court below correctly did so by relying on the applicable rules' plain language as well as their regulatory history – once again, something courts around the country do routinely. In doing so, the Third Circuit has given the Commission's no-action letters and belated *amicus* brief the degree of deference to which they are entitled under this Court's precedents including the case of *Christensen v. Harris County*, 529 U.S. 576, 588 (2000), a decision which petitioners neglect to cite in their writ.

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[3] Commission rules and regulations are interpreted in the same manner as statutes. *See, e.g., Rosenberg v. XM Ventures*, 274 F.3d 137, 142 (3d Cir. 2001).

There is also no merit to petitioners' assertion that the decision below conflicts with the decision in *Gryl v. Shire Pharmaceuticals Group, PLC*, 298 F.3d 136 (2d Cir. 2002). The court below carefully and correctly distinguished *Gryl*. Unlike this case, *Gryl* did not address the issue of whether a transaction must have a compensatory purpose to be eligible for the Rule 16b-3 exemption.

A. The Ruling Below was Correct

1. Rule 16b-3(d) was Correctly Interpreted

a. The Plain Meaning of Rule 16b-3(d) Supports the Court of Appeals' Interpretation

Rule 16b-3(d) allows for the exemption of "a grant, award or other acquisition from the issuer" from Section 16(b) liability. *See* 17 C.F.R. §240.16b-3(d). This Court adheres to the principle of statutory interpretation known as *esjudem generis*, which requires that "the residual clause [*i.e.*, "other acquisition"] should be read to give effect to . . . [and] be controlled and defined by reference to the enumerated categories [*i.e.*, "grant and award"] which are recited just before it." *Circuit City Stores v. Adams*, 532 U.S. 105, 115 (2001).

The terms "grant" and "award" involve compensation. The SEC's adopting release accompanying its promulgation of Rule 16b-3 states: "'grant and award' transactions provide issuer securities to participants on a basis that does not require either the contribution of assets or the exercise of investment discretion by the participants." *Ownership Reports and Trading by Officers, Directors and Principal Security Holders*, Release No. 34-37260, 61 FR 30376, 30380 (May 31, 1996) ("Adopting Release"). Construing Rule 16b-3(d) under this principle of statutory

construction, the term "other acquisition" must be understood as denoting a form of compensation consistent with the use of words "grant" and "award" as the Commission has defined them, and construed "to embrace only objects similar in nature to those objects enumerated in the preceding specific words." *Circuit City Stores*, 532 U.S. at 114-15.

b. The Statutory Policies of Section 16(b) Support the Court of Appeals' Interpretation of Rule 16b-3(d)

Ejusdem generis is given effect when it is in accord with other sound considerations. *Circuit City Stores*, 532 U.S. at 115. Here, those sound considerations are the statutory policies underlying Section 16(b) and the regulatory history of Rule 16b-3(d), which support the court of appeals' interpretation.

The statutory policies of Section 16(b) are designed to prevent speculative abuse by statutory insiders. *See* Point I.B, *supra*. Petitioners, however, cannot plausibly explain how speculative abuse in securities trading would be curbed if Rule 16b-3(d) were read to encompass ***all*** transactions with the issuer rather than only those that are compensation-related. Instead, they seek to turn the statute on its head by arguing that the statute's purpose is to exempt compliant insiders from liability because its imposition is disruptive to the free functioning of the securities markets. Petitioners' argument overlooks the fact that Section 16(b) embodies Congress' judgment that certain types of insider trading are so fraught with the risk of speculative abuse that they are subject to a *per se* rule, *i.e.*, they should not be allowed under any

circumstances. *Accord Foremost-McKesson, supra*. Though petitioners may differ with respect to the wisdom of that legislative judgment, the Commission lacks authority to unilaterally repeal the statute. Instead, as stated in Section 16(b) itself, the Commission may exempt only transactions that are "not comprehended within the purpose of this subsection." *See* 15 U.S.C. §78p(b).

Petitioners tardily joined by the Commission below, suggest that routine "gatekeeping" procedures requiring approval by an issuer's directors or shareholders are sufficient to protect against speculative abuse by insiders. However, Section 16(b) is predicated on the principle that insiders are tempted and able to manipulate corporate affairs to their advantage. Release 18114, 46 FR at 48147 & n.3. As the court of appeals correctly recognized, allowing corporate directors to exempt transactions from the statute's coverage would be fundamentally inconsistent with Section 16(b)'s provision that limits the same directors from preventing the prosecution of a lawsuit – a suit any shareholder is entitled to bring even if the directors ignore or reject his pre-suit demand.[4] *See* 15 U.S.C. §78p(b), *accord Burks v. Lasker*, 441 U.S. 471, 484 n.13 (1979) (Congress intended to prevent boards of directors from cutting off shareholder lawsuits brought pursuant to Section 16(b).)

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[4] The Commission itself appears to be retreating from its reliance on the "gatekeeping" fiction. *See Ownership Reports and Trading by Officers, Directors and Principal Security Holders*, Exchange Act Release No. 46421, 2002 SEC LEXIS 2227 at *28-29 (Aug. 27, 2002) (requesting comment as to whether Rule 16b-3(d) should require a six-month holding period as a mandatory condition).

c. The Regulatory History of Rule 16b-3(d) Also Supports the Court of Appeals' Interpretation of the Rule

The regulatory history of Rule 16b-3(d) further supports the conclusion that it is concerned solely with compensation-based transactions. Indeed, Rule 16b-3 has long been understood to be concerned with allowing the use of issuer stock and stock options in compensation plans. *E.g.*, *Notice of Proposed Amendment of Rule 16b-3 Under the Securities Exchange Act of 1934*, Exchange Act Release No. 6111, 1959 SEC LEXIS 199 at *8-10 (Nov. 5, 1959). *See also* Release No. 18114, 46 FR at 48163; Exchange Act Release No. 12374, 1976 SEC LEXIS 1831 at *3 (1976); Exchange Act Release No. 7723, 1965 SEC LEXIS 741 (1965).

Rule 16b-3's extensive revision in 1991 included a rather complex and detailed set of rules governing the availability of the compensation-related exemption. The rule's complexity caused "unanticipated practical difficulties." *Ownership Reports and Trading by Officers, Directors and Principal Security Holders*, Release No. 34-34514, 59 FR 42449 at 42449 (Aug. 17, 1994) ("1994 Release"). New revisions to Rule 16b-3 proposed in 1994 were designed to "address these practical problems and further streamline the rules, to the extent consistent with the purposes of Section 16." *Id.*, 59 FR at 42449. The proposal sought to amend Rule 16b-3(d) to "exempt, without conditions as to timing, any purchase transaction arising under a broad-based nondiscriminatory tax-qualified plan, other than an intra-plan transfer to or from an employer securities fund." *Id.*, 59 FR at 42450. The 1994 Release contains no mention of any intent to provide a blanket exemption for all transactions between an issuer and its directors.

Reacting to further comment, the SEC sought to expand the scope of the proposed new Rule 16b-3(d) to allow "any acquisition or disposition of issuer equity securities . . . [to] be exempt without condition if made pursuant to a plan. . . . " *Ownership Reports and Trading by Officers, Directors and Principal Security Holders*, Release No. 34-36356, 60 FR 53832, 53834 (Oct. 17, 1995) ("1995 Release"). The 1995 Release evinced the Commission's intent to avoid exempting ordinary volitional transactions between an issuer and a director. *Id.* & nn.30 & 31. *Accord* Release No. 18114, 46 FR at 48163 (Rule 16b-3 exemption unavailable where employee retains an element of volition over the timing of his purchase of securities).

The 1995 Release also explained that the purpose of the alternative proposal, later adopted as the Rule, was to facilitate ***compensation-related transactions*** between an issuer and its officers and directors. Thus, the 1995 Release stated:

> Through the Alternative Proposal, the Commission has sought to craft a rule that, consistent with the statutory purpose of Section 16(b), erects meaningful safeguards against the abuse of inside information by officers and directors ***without impeding their participation in legitimate compensatory transactions*** that do not present the possibility of such abuse, and facilitates compliance. In so doing, the Commission has recognized that ***most, if not all, transactions between an issuer and its officers and directors are intended to provide a benefit or other form of compensation to reward service or to incentivize performance.***

1995 Release, 60 FR at 53833 (emphasis added).

The final release issued by the SEC with respect to Rule 16b-3 confirms that the concept of compensation lay at the core of the regulatory changes to Rule 16b-3(d). In connection with the decision to insert the words "other acquisitions" the Adopting Release states:

> [The] [p]urpose is to exempt some participant directed transactions (such as deferral of bonuses into phantom stock and other deferred ***compensation programs***) that are exempt under the current rule but would lack the exemption under the new rule.

Adopting Release, 61 FR at 30380 (emphasis added). The Commission has never stated in any release contemporaneous with the adoption of the rule that Rule 16b-3(d) provides a blanket exemption for all acquisitions of securities by a director from an issuer.

The portions of the regulatory history upon which petitioners rely do not detract from Rule 16b-3(d)'s intent as unequivocally expressed in the regulatory history through, *inter alia*, the 1994 Release, the 1995 Release, and the Adopting Release. Petitioners wrenched those quotes out of context because "the surrounding language is concerned with compensation." *Levy*, 314 F.3d at 123 n.13.

One such quote from the Adopting Release is that "[t]ypically, where the issuer rather than the trading markets, is on the other side of [a] . . . director's transaction in the issuer's equity securities, any profit obtained is not at the expense of uninformed . . . market participants. . . . " SEC *Amicus* Brief at 6; 72a-73a (quoting Adopting Release, 61 FR at 30377). However, the Commission overlooked the fact that the same statement was made in 1995 when it put out for comment an earlier

proposed version of the rule. *See* 1995 Release, 60 FR at 53833. In 1995, the statement was meant to serve as the rationale for exempting only "Grant or Award Transactions," at that time denominated as Rule 16b-3(c). *Id.* 60 FR at 53840. No mention at all was made of the term "other acquisition" in the 1995 Release. *Id.*

There is therefore no basis for concluding that this broadly worded rationale was intended to exempt ***all*** transactions between an issuer and its directors. Instead, the language of the draft rule was changed in the final version because some "participant-directed transactions . . . that are exempt under the current rule would lack an exemption under the new rule." 314 F.3d at 123-24 (quoting Adopting Release, 61 FR at 30380).

The Commission misleadingly focuses on the statement in the Adopting Release that transactions "that satisfy [certain] objective gate-keeping conditions, are not vehicles for the speculative abuse that Section 16(b) was designed to prevent" (Adopting Release, 61 FR at 30377 (quoted in SEC *Amicus* at 6-7)). If that rationale were the rule – which it is not – ***all transactions involving an issuer would be exempt, not merely those involving directors and officers but also those involving 10% beneficial owners.***

Rationales are not coextensive with rules or statutes. *Nat'l Industrial Sand Ass'n v. Marshall*, 601 F.2d 689, 711-12 (3d Cir. 1979). Even petitioners do not argue that Rule 16b-3(d) exempts transactions between a 10% beneficial owner and an issuer. Nor are all transactions between a director and an issuer exempt if approved by the directors. Instead, as the court below correctly concluded, the rule means what both its text and regulatory history say: only

compensation-related transactions similar to "grants" and "awards," and no other, are eligible for the Rule 16b-3(d) exemption.

2. Petitioners' Position on Rule 16b-3 Ignores the Facts of This Case

Petitioners overlook the fact that Rule 16b-3(d)'s exemption cannot apply to this action under any set of circumstances. The only facts in the record which potentially implicate the exemption are that the subject purchase was "approved by the written consent of the owners of the majority of Fairchild's securities." SEC *Amicus* at 5; 71a (citing Complaint ¶20; A-24). However, the Commission failed to inform the court of appeals (as petitioners fail to inform this Court) that it previously took the position that "a statement of purpose is required where shareholder approval is the basis for the exemption." Brief of the SEC, *Amicus Curiae* filed in *Gryl v. Shire Pharmaceuticals Group, PLC,* No. 01-9130 at 26 n.23 (2d Cir.)[5] (citing Adopting Release, 61 FR at 30382). Nothing in the record before this Court evidences the existence of any such statement of purpose, to wit, that Fairchild's shareholders approved the transactions in question with the stated purpose of exempting those transactions from Section 16(b) liability. Therefore, even under the SEC's position taken before the circuit court, Rule 16b-3(d) is inapplicable to the facts of this case.

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[5] This SEC brief was previously filed with the Court below as Exhibit C to Appellant's Response to Appellee's Motion to Strike, dated September 20, 2002. Copies of this and the other SEC *amicus* brief cited in this brief will be lodged with this Court upon request.

3. The Court of Appeals Correctly Interpreted Rule 16b-7(a)

a. Rule 16b-7 Contains no Exemption for Reclassifications

Rule 16b-7 does not contain the term "reclassification." *See* 17 C.F.R. §240.16b-7. The word is found only in the title of the rule exempting only transactions that are "mergers" and "consolidations." The heading of a statute (or regulation) is not utilized in interpreting the plain meaning of a statute. *See, e.g., Pennsylvania Dep't of Corrections v. Yeskey*, 524 U.S. 206, 213 (1998); *Minnesota Transp. Regulation Bd. v. U.S.*, 966 F.2d 335, 339 (8th Cir. 1996).

The terms "merger" and "consolidation" have well-understood common law meanings, neither of which includes anything resembling the "reclassification" which Petitioners seek to exempt. *See* 15 *Fletchers Cyclopedia of Corporations* §7041 at 8-12 (1999). The SEC is not free to reinterpret the common law meaning of those terms. *Accord Jicarella Apache Tribe v. FERC*, 578 F.2d 289, 292-93 (10th Cir. 1978). There is therefore no exemption for reclassifications outside the context of mergers and consolidations. *Cf. Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994) (no cause of action for aiding and abetting a violation of Section 10(b) of the Exchange Act exists because the statute does not expressly provide for such a claim).

To the extent any rule on the topic exists it is that "Rule 16b-7(a) *can* apply to transactions involving reclassifications." Release No. 18114, 46 FR at 48177. Through the use of the word "can," the rule – assuming it exists – would be permissive. *See Sverdrop v. WHC*

Contractors, Inc., 989 F.2d 138, 151 (4th Cir. 1993). Thus, as phrased, the interpretive release states only that where a merger or consolidation which otherwise falls within the ambit of Rule 16b-7(a) *also involves a reclassification*, the exemption *may* still apply. In that regard, it is particularly telling that Question 142, within which this discussion is contained, analyzes a series of hypothetical scenarios, none of which implicates a pure reclassification existing outside the context of a merger or a consolidation. Release 18114, 46 FR at 48177.

b. SEC No-Action Letters do not Support the Existence of an Exemption

"Commission no-action and interpretive letters are not official expressions of the Commission's views and do not have the force of law." Brief of the Securities and Exchange Commission, *Amicus Curiae*, in Support of Appellant and Issues Addressed, *Morales v. Quintel Entertainment, Inc.*, 99-9374 (2d Cir.) at p.15 n.9 (citing *New York City Employees' Retirement System v. Securities and Exchange Commission*, 45 F.3d 7, 12-13 (2d Cir. 1995)); *see also Christensen*, 529 U.S. at 587. Instead, "SEC no-action letters constitute neither agency rule-making nor adjudication and thus are entitled to no deference beyond whatever persuasive value they might have." *Gryl*, 298 F.3d at 145 (citing cases).

Moreover, the no-action letters upon which petitioners rely do not support their position. *Monk-Austin, Inc.*, SEC No-Action Letter, [1992] Fed. Sec. L. Rep. (CCH) ¶76,296 (Nov. 19, 1992), is inapposite because it involved preferred stock which was always convertible into common stock. *Id.* at *1. The recapitalization there eliminated only different

classes of common stock, changing the common stock into which the preferred stock was convertible from Class B common to ordinary common stock. *Id.* No change in the proportionate interests of the shareholders was affected. *Id.* at *6 and *8.

In contrast, here the Preferred Stock was *not* originally convertible into Common Stock. A-24. Thus, at issue here is not the reclassification of one type of common stock into an another economically equivalent class of common stock, but rather the change from the fixed contractual rights of preferred shareholders to those of complete residual equity ownership embodied by common stock. In other words, petitioners acquired an equity interest they did not own prior to the conversion of the Preferred Stock.

St. Charles Acquisition Ltd. Partnership, SEC No-Action Letter, [1992] Fed. Sec.. L. Rep. (CCH) ¶76,223 (June 25, 1992), is similarly inapposite. In *St. Charles*, the economic interests of a limited partnership were to be converted to corporate form with no change in proportionate ownership interests. *Id.* at *5 Here, however, as demonstrated above, there was a very real change in the economic substance of the investments that petitioners previously held in the form of Fairchild preferred stock.[6]

[6] Furthermore, the term "recapitalization," which the Commission at times appears to use interchangeably with "reclassification," is contained in Rule 144(d)(3)(I) of the Securities Act. *See* 17 C.F.R. §230.144(d)(3)(I). Defendants' transactions in Common Stock, however, would not fit within the meaning of the term as used in that portion of the federal securities laws. *See, e.g., Cable TV Industries*, 1981 SEC No-Act. LEXIS 3958 (Aug. 31, 1981) (request for no-action refused because of "a shift of the economic risks involved" resulting from less than 1½%

(Continued on following page)

c. The SEC Arguments Lack Merit

As the SEC acknowledged in their *amicus* submission below, the interpretation it sought to advance for petitioners' benefit with respect to Rule 16b-7's scope greatly exceeds the rulings in *Kern County, supra*, and *Roberts v. Eaton*, 212 F.2d 82 (2d Cir. 1954). *See* SEC *Amicus* at 10; 76a. Yet if that had been the SEC's intent, it would have stated so explicitly in its release, as it has done on other occasions where it wished to note a newly adopted rule's inconsistency with previously existing cases. *See, e.g., Ownership Reports and Trading by Officers, Directors and Principal Security Holders*, Exchange Act Release No. 28869, [1991] Fed. Sec. L. Rep. (CCH) ¶84,709 at 81,261-81,263 & nn.116 and 117 (Feb. 8, 1991). *Accord Hillsborough County v. Automated Med. Lab., Inc.*, 471 U.S. 707, 718 (1985) (agencies must make clear any intention to displace existing state law).[7]

Similarly, the rationales which the SEC advanced in favor of its broad reading of Rule 16b-7 were arbitrary and unsupported by any contemporaneous evidence of its

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of the new company's stock being owned by people who were not shareholders of the predecessor company.) *Accord William S. Smith*, 1993 SEC No-Act. LEXIS 455 (March 16, 1993) (rejecting request for no-action letter); *Capital Bancorp*, 1983 SEC No-Act. LEXIS 1710 (July 31, 1983) (same).

[7] Nor is it clear that the SEC has the authority to exempt reclassifications on terms other than those enunciated in *Kern*. An administrative agency is not free to redefine the contours of a statute after this Court has spoken as to its proper interpretation. *See, e.g., Neal v. U.S.*, 516 U.S. 284, 295 (1996) ("Once we have determined a statute's meaning, we adhere to our ruling under the doctrine of *stare decisis*, and we assess the agency's later interpretation of the statute against settled law.")

intentions. Essentially the SEC argued that petitioners' transactions would have been exempt if structured as a merger rather than a reclassification. *See Amicus* at 14; 77a-78a. However the merger that the SEC describes would, in fact, be deemed a liquidation, and therefore *not* be eligible for the Rule 16b-7 exemption. *See* Release No. 18114, Question 142, Illustration (2), 46 FR at 48177.

There was (and is) no merit to the SEC's claim that Section 16(b) liability should not attach because there is no change in the "company's business." SEC *Amicus* at 12; 78a. Such is always almost the case in securities transactions subject to Section 16(b). There is rarely a change in the issuer's business; the only thing that changes is the economic interest of the statutory insider. Indeed, if a change in business were the *sine qua non* of Section 16(b) liability there would never be any Section 16(b) liability.[8]

Finally, the SEC's claim that there was no change in petitioners' economic position as a result of the reclassification (*see* SEC *Amicus* at 13; 79a) is clearly incorrect. In reality, petitioners acquired millions of shares of Fairchild stock at $17.39 per share (A-25) while the IPO price was priced at $18.50 per share (*see* A-84), and as a "hot" IPO, soon skyrocketed in price. The economic change was so great that defendant National Semiconductor recorded a $48.4 million gain upon completion of Fairchild's IPO before it ever sold a single share of stock. *See* National Semiconductor Form 10-Q dated 10/13/99 at Item 2

[8] Respondent notes that no such defense was raised in *Colan v. Mesa Petroleum Corp.*, 951 F.2d 1512 (9th Cir. 1991), in which defendants were represented by capable and sophisticated counsel.

(available at http://www.sec.gov/Archives/edgar/data/70530/000070530-99-000008.txt).

B. The SEC's Views Were Given the Deference to Which They Were Entitled

Implicitly recognizing that the plain language and regulatory history of Rules 16b-3 and 16b-7 support the conclusion reached below, petitioners argue that the decision conflicts with this Court's precedents governing the level of deference afforded to an administrative agency's interpretations of its regulations. Petitioners, however, overlook *Christensen v. Harris County*, 529 U.S. 576, 588 (2000), where the Court declined to defer to an administrative agency's proffered interpretation of its own regulation which was contrary to its plain meaning. *Accord Norfolk Southern Ry v. Shanklin*, 529 U.S. 344, 356 (2000) (no deference afforded to administrative agency's interpretation contrary to the regulation's plain text). Indeed, in *Bowles v. Seminole Rock & Sand Co.*, 325 U.S. 410 (1945), petitioners' seminal case for agency deference, the Court rested its deference on "a bulletin issued by the Administrator ***concurrently*** with the . . . Regulation." 325 U.S. at 417 (emphasis added). Here, as discussed in greater detail above in Point III.A, both the plain language and the ***concurrent*** regulatory history compel the interpretation of the subject regulations embraced by the Third Circuit.

Moreover, petitioners overlook the fact that deference to an agency's interpretation of a regulation is warranted only where the agency is "charged with administering the law." *Director, OWCP v. Eastern Associated Coal Corp.*, 54 F.3d 141, 149 (3d Cir. 1995); *accord Martin v. Occupational*

Safety and Health Review Comm'n, 499 U.S. 144, 157 (1991); *Adams Fruit Co. v. Barrett*, 494 U.S. 638, 649-50 (1990). But, the SEC has ***no enforcement, administrative, or adjudicative authority*** over a claim arising under Section 16(b). *See, e.g., Gollust*, 501 U.S. at 122.[9] The absence of deference the courts afford the SEC with respect to Section 16(b) is further evidenced by the fact that, both before and after its ruling in *Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984), this Court has never accorded deference to the SEC with respect to its proffered interpretations of Section 16(b). *See Gollust, supra*;[10] *Reliance Electric*, 404 U.S. at 426-27; *Blau v. Lehman*, 386 U.S. 403, 413 (1962); *accord Foremost-McKesson*, 423 U.S. at 259-60.[11]

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[9] Even the SEC's authority to exempt a transaction is statutorily limited to transactions "not comprehended within the purpose" of the statute (15 U.S.C. §78p(b)). It must therefore be akin to the two specific statutory exemptions contained in the body of Section 16(b) which do not provide an opportunity for speculative abuse. *See, e.g., Feder v. Martin-Marietta Corp.*, 406 F.2d 260, 268 (2d Cir. 1969), *cert. denied*, 396 U.S. 1036 (1970); *Smolowe v. Delendo*, 136 F.2d 231, 240 (2d Cir. 1943).

[10] *Gollust* rejected a proposed SEC rule to govern standing to sue in Section 16(b) actions. *See* A. S. Jacobs, *Section 16 of the Securities Exchange Act*, §3:36 at 3-301 (July 2002) (SEC proposed a Rule 16a-1(h) with a different rule of standing than the one adopted in *Gollust*).

[11] The lower courts have likewise rejected positions taken by the SEC regarding the proper interpretation of Section 16(b) and the validity of related regulatory exemptions. *See, e.g., Feder*, 406 F.2d at 268-69; *B.T. Babbit, Inc. v. Lachner*, 332 F.2d 255 (2d Cir. 1964); *Greene v. Dietz*, 247 F.2d 689 (2d Cir. 1957); *Colema Realty Corp. v. Bibow*, 555 F. Supp. 1030 (D. Conn. 1983); *Perlman v. Timberlake*, 172 F. Supp. 246 (S.D.N.Y. 1959).

This is particularly true with respect to Rule 16b-7 which assuming *arguendo* it contains any rule exempting reclassifications is at most a permissive rule through the use of the word "can" in the relevant interpretative release. *See* Point III.A.3.a, *supra*. In such circumstances, courts are free to interpret a permissive rule without regard for an agency's views. *Christensen*, 529 U.S. at 588.

In cases such as this, where a rule's language and history are clear, "to defer to the agency's position would be to permit the agency, under the guise of interpreting a regulation, to create *de facto* a new regulation." *Christensen v. Harris County*, 529 U.S. 576, 588 (2000); *Caruso v. Blockbuster-Sony Music Entertainment Center at the Waterfront*, 193 F.3d 730, 737 (3d Cir. 1999) ("'An agency is not allowed to change a legislative rule retroactively through the process of disingenuous interpretation [of] the rule to mean something other than its original meaning.'" (citations omitted)). *Christensen* clearly held that the deference otherwise required under *Auer v. Robbins*, 519 U.S. 452, 461-63 (1997), is unwarranted in such circumstances. 529 U.S. at 588.[12]

To the extent the SEC, with its recently revised interpretations of Rules 16b-3 and 16b-7 set forth in its *amicus* brief below, seeks to promulgate new regulatory exemptions under Section 16(b), any question as to the validity of such exemptions under the statute is not entitled to *Chevron*-style deference. Such pronouncements

[12] *Barnhalt v. Walton*, 535 U.S. 212 (2002) is not to the contrary as all parties agreed that the agency, in question, had "properly interpreted its own regulation." *Id.* at 217.

are similar to the opinion letter discussed in *Christensen* in that they were not subject to the notice-and-comment requirements of the Administrative Procedure Act. *Christensen*, 529 U.S. at 587 (interpretations contained in formats such as opinion letters are only entitled to respect under *Skidmore v. Swift & Co.*, 323 U.S. 134, 140 (1944)); *See also Matz v. Household International Tax Reduction Investment Plan*, 265 F.3d 572, 574 (7th Cir. 2001) (agency positions taken in *amicus* briefs are informal agency policy pronouncements not entitled to deference). This is particularly relevant here where Section 16(b) exemptions must by statute be adopted through "rules and regulations." 15 U.S.C. §78p(b). *Accord Kzralic v. Republic Tire Co.*, 314 F.3d 875, 882 (7th Cir. 2002) (Easterbrook, J., concurring) (when a statute is enforced through private litigation "the views of a federal agency achieves only binding effect when incorporated into legislative regulations under delegated powers.") (citing *Adams Fruit*, 494 U.S. at 649-50).

C. The Decision Below did not Create any Conflict Within the Circuits

Petitioners suggest that the decision below conflicts with *Gryl v. Shire Pharmaceuticals Group, PLC*, 298 F.3d 136 (2d Cir. 2002). However, the Court below carefully distinguished *Gryl* as involving a case in which the options at issue had a compensatory nexus. *See Levy*, 314 F.3d at 124.

This distinction is correct. Underlying the discussion and decision in *Gryl* is the bedrock assumption that the transaction at issue involved a "grant, award or other acquisition" within the meaning of Rule 16b-3(d)(1). *Gryl*,

298 F.3d at 141. The sole issue addressed in *Gryl* was whether purpose-specific authorization from an issuer's board of directors was required to qualify for the Rule 16b-3(d)(1) exemption. *Gryl*'s limited focus is well demonstrated by the *amicus* brief timely submitted by the SEC and whose guidance the Court of Appeals found persuasive. *Id.*, 298 F.3d at 145. The SEC's *amicus* brief in *Gryl* demonstrates that in that case, the Second Circuit neither considered nor decided the meaning of the term "other acquisition" as used in Rule 16b-3(d)'s phrase of "grant, award, or other acquisition."

D. There is no Evidence That the Court of Appeals' Decision has Caused, or Threatens to Cause, any Disruption in the Financial or Other Markets

The court of appeals issued its ruling more than eight months ago. Yet petitioners cannot point to a single article in any publication supporting their position that the decision has caused, or threatens to cause, disruptions in the markets.

Section 16(b) itself has been operative since 1934. The statute, and the entire structure of regulation introduced by the federal securities laws, were initially derided by "experts" who claimed that the passage of such laws would cause "grass to grow on Wall Street." J. Landis, *The Legislative History of the Securities Act of 1933*, 28 Geo. Wash. L. Rev. 29, 35 & n.16 (1959). Nonetheless, in the 70 years since the federal securities laws were first adopted, the securities markets have thrived with occasional sharp reminders to the public that regulation and deterrence of

some of the more dangerous practices are a benefit to the markets and society as a whole.

CONCLUSION

The petition for a writ of Certiorari should be denied.

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Respectfully submitted,

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